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Comments on the OECD Discussion Draft on Financial Transactions

Working Party No. 6 – Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

To

BonelliErede – Valdani Vicari & Associati

From

Comments on the Discussion Draft on Financial Transactions

Reference

6 September 2018

Date

Dear Sirs/Madams

BE–VVA[1] would like to thank you for the work done in drafting the BEPS Action 8–10 Discussion Draft on Financial Transactions ("**Draft**") and are pleased to provide a preliminary set of comments and observations to contribute to the Draft's implementation along with a brief introduction to the commented topics.

[1] BE–VVA is an exclusive alliance in the field of transfer pricing created by the law firm BonelliErede ("**BE**") and the economic consultancy firm Valdani Vicari & Associati ("**VVA**"). BE-VVA combines a team of tax experts who hold prestigious positions at major universities teaching taxation and transfer pricing and a team of fully dedicated economists focused on economic consultancy in the fields of valuation, transfer pricing and commercial litigation.

Introduction to our comments

BE–VVA would first like to thank the OECD for its commitment in trying to reduce tax uncertainty regarding transfer pricing matters. BE–VVA welcomes the Draft as a fundamental step towards providing guidance on a matter that is gaining increasing importance in the transfer pricing arena, as shown by landmark court cases.

Our comments refer to both selected boxes and selected paragraphs. When we do not cover all the queries mentioned in one box, we specify the query and argument addressed. When our comments relate to either more than one paragraph or boxes and paragraphs together, reference is made to the paragraphs or both the boxes and the paragraphs, respectively.

Executive summary

One of the most significant techniques in the international tax arena for shifting profits relates to financial transactions. The OECD has devoted a great deal of effort to trying to resolve the underlying issues (among others, by issuing BEPS Actions 4 and 8–10) and to set out fundamental principles to reduce profit shifting.

The recurrent theme of the OECD's efforts can be seen in BEPS Actions 8–10, which clarify that funding companies should merely be entitled to a risk-adjusted rate of return.

The OECD principles are very much in line with landmark court cases and tax legislation interventions by the European Union (e.g., ATAD 1 and 2).

In light of this, and considering the importance of ensuring continuity and harmonisation in interventions on the matter, we structured our comments to follow the topics set out by the OECD, with particular focus on: (i) interaction with the guidance in Chapter 1, Section D.1 of the OECD Transfer Pricing Guidelines; (ii) intragroup loans; and (iii) cash pooling.

Interaction with the guidance in Chapter 1, Section D.1 of the OECD Transfer Pricing Guidelines

With regard to Chapter B of the Draft, we first analyse the interaction between the recharacterization of a transaction and Arts. 9 and 25 of the OECD MTC and

BEPS Action 4 (Box B.1). We raise our concern as to whether the Draft's recommended approach (willing to lend/willing to borrow) suffices to resolve the problems relating to double taxation.

Subsequently, we examine the example of para. 17 (Box B.2) and provide some hints on its possible implementation and the practical implications that could arise regarding the concept of "maximum amounts".

We then analyse the concepts outlined in paras. 17, 19 and 34 on financial projections and the ability to service the loan. We focus on: (i) the connection with Chapter VI of the TPG; (ii) the relevant flows to be considered (whether cash or income, net or operating); (iii) the purpose of financial projections; and (iv) the concerns deriving from the possible absence of financial projections.

We then welcome the provisions on the factors to be taken into account in analysing financial transactions (Box B.3) and suggest some additional factors that could be included in the list. We also suggest to parameter the breadth of the analysis to the materiality of the transaction and the size of the multinational group.

Finally, we provide our view on the risk-free and risk-adjusted rate of return (Box B.4). With regard to the risk-free rate of return, we mention some key points relating to the financial instrument to be considered and the maturity of the risk-free investment. With regard to the risk-adjusted rate of return, we provide a non-exhaustive list of technical issues that could impact the calculation of the risk-adjusted rate of return.

Intra-group loans

With regard to Chapter C.1 of the Draft, we first focus on the concept introduced in para. 52 and raise our concerns regarding: (i) its compliance with the separate entity approach principle, and (ii) its possible practical implications in terms of burdening the taxpayer's effort and tax certainty.

Moreover, we provide our viewpoint on the group credit rating (Box C.2), focusing on the benefits of tax compliance and consistency with the separate entity approach.

Cash pooling

With regard to Chapter C.2 of the Draft (Box C.8), we first provide a practical example of a cash pool leader acting as an entrepreneur and examine its functional profile. We then focus on the approaches for allocating cash pooling benefits and provide examples based on our experience. Subsequently we provide a possible three-step analysis to determine the remuneration of the cash pool members (both when the cash pool leader acts as an entrepreneur and when it does not).

We then analyse the transfer pricing consequences of a member being obliged to participate in a cash pool (Box C.9).

Finally, we examine the treatment of surpluses in a cash pooling arrangement (para. 106) and suggest some practical approaches to address the topic.

Box B.1. Commentator's views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report

One of the most relevant issues relating to intercompany transactions is understanding whether and to what extent a financial transaction exists as characterized by the taxpayer. This is of paramount importance given the implications that characterizing a debt into equity may have not only on transfer pricing but also on corporate income tax and the tax treatment of the related proceeds (as either interest or dividends).

The OECD initially partially addressed this matter in its 1979 report on "Transfer Pricing and Multinational Enterprises", which described the different approaches adopted by countries to distinguish an equity contribution from a loan. The report recommended that countries adopted a flexible approach in which the special conditions of each individual case had to be evaluated. Afterwards, the OECD report on thin capitalisation addressed in more depth the applicability of the arm's length principle to characterize debt as equity.

The current Draft, in compliance with the principles stated in Chapter I of the OECD Transfer Pricing Guidelines ("**TPG**"), provides a list of economically relevant characteristics of financial transactions that should be taken into account to accurately characterize a transaction. We deem advisable that a more detailed guidance

should be provided on the useful indicators for establishing the nature of an advance of funds. Particularly, it should be explained how any indicator might suggest the nature of the transaction (e.g., whereas it is quite intuitive the potential relevance of the presence or absence of a fixed repayment date, the reference to "the source of the interest payments" or to the use of the funds "to acquire capital assets" is less clear; moreover, the "ability of the recipient of the funds to obtain loans from unrelated lending institutions" seems to partially overlap the criterion of "willing to lend" mentioned under para. 17).

We point out that also the Commentary to Art. 10 of the OECD MTC deals with the possibility to consider interest on loans as dividends "... insofar as the lender effectively shares the risks run by the company ..." (in para. 25) (and provided, on the basis of Art. 10, para. 3, of the OECD MTC, that this income is treated as dividend by the domestic law of the State of residence of the payer). Whether this is the case must be determined on the basis of the several criteria listed by the Commentary (e.g., whether the repayment of the loan is subordinated to claims of other creditors, the absence of fixed repayment date). Some of these relevant factors resemble the economically relevant characteristics mentioned by the current Draft. It would be therefore advisable to clarify the interaction between the analysis to be carried to accurately delineate an advance of funds for transfer pricing purposes and the guidance provided by the Commentary to Art. 10 of the OECD with respect to loans whose proceeds falls in the scope of the definition of dividends provided by Article 10, para. 3, of the OECD MTC.

It is also worth mentioning that the TPG state (in para. 1.122) that the non-recognition of an actual transaction should be carefully applied as it can be contentious and a source of double taxation. This is particularly true in financial transactions as countries may have different approaches to characterizing a financial instrument as debt or equity. Indeed, some jurisdictions have a comprehensive definition of debt and equity, whereas others simply list specific types of transactions that can be treated as debt or equity.

Consequently, the risk of economic double taxation becomes extremely high and the conventional tools for limiting or avoiding its detrimental effects may not be sufficient in light of the high degree of judgmental criteria.

For transfer pricing purposes, tailored guidelines should therefore be provided to properly characterize intercompany debt, also taking into account that the high degree of integration of MNEs may prevent market comparable transactions from be-

ing identified. Given that this situation, as recognised by the OECD guidelines, does not exclude a transaction being at arm's length, it should be evaluated whether the approach recommended in the Draft for establishing whether and to what extent a financial transaction should not be recognised (willing to lend/willing to borrow) suffices to solve the problem.

Box B.2. Commentators' views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

As a general comment, we believe that additional elaboration of the example contained in para. 17 is required to provide practical guidelines to tax authorities and taxpayers. For instance, the example could better explain: (i) the relevant characteristics of both the companies involved and the loan, (ii) the considerations behind the conclusion that an unrelated party would not be willing to provide such a loan, (iii) the options realistically available to the parties involved, and (iv) the consequences of recharacterizing the loan as equity from an economic and tax perspective.

With regard to the amount that may not be recharacterized, we welcome the reference to the concept of maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow rather than recharacterizing the entire transaction. In this respect, the following two cases can be identified:

(i) only one of the "maximum amounts" (from either the lender's or the borrower's perspective) is lower than the debt amount: in this case, the portion of debt to be delineated as equity corresponds to the difference between the maximum amount (the one lower than the debt amount) and the debt amount; and

(ii) both the "maximum amounts" (from both the lender's and the borrower's perspective) are lower than the debt amount: in this case, the portion of

debt to be delineated as equity corresponds to the difference between the lowest of the maximum amounts and the debt amount.

If even only one of the two "maximum amounts" is equal to zero, the entire loan amount must be delineated as equity (the entire interest amount is not deductible).

In all other cases, the reduction of the loan amount is always partial, and, consequently, the reduction of interest deductibility.

We also wonder whether the "maximum amounts", determined based on the analysis of both the lender's and the borrower's ORAs, could also be determined based on "cost of capital optimisation", as there is always, at least theoretically, an optimum debt to equity ratio that minimises the cost of capital, rather than average industry ratios.

Finally, we wonder whether the "maximum amounts" should be determined based on pre-money or post-money scenarios, given that pre-money scenarios are based on balance sheets reflecting a historical state, whereas post-money scenarios are based on ad hoc financial projections that reflect an envisaged future condition.

Theoretically, post-money scenarios should be preferred to pre-money scenarios because this is exactly what a lender is interested in when evaluating the capacity to service the loan and the borrower's creditworthiness.

Nonetheless, to reduce the burden for the taxpayer that needs to draw up ad hoc financial projections, a possible "short-cut" solution could be a "post-money scenario" based on the "alteration" of balance sheets (e.g., more debt matched with more tangible investments or cash, all else being equal).

The topic of pre- or post-money scenarios is indeed also an issue when dealing with the measurement of credit ratings (see Section C.1.2), particularly considering that analytical credit rating tools (e.g., Moody's RiskCalc) are fed by balance sheet ratios, which are historical by nature.

Paras. 17, 19, 34. On financial projections and ability to service the loan

We deem it would be appropriate to provide guidance on the presumed "all good-faith financial projections" (see para. 17).

The first consideration regards the possible connections and the consequent combined interpretation with Chapter VI of the TPG on the reliability of projections in evaluation techniques.

Second, to properly assess the ability to service the debt in financial transactions, the relevant flows should be cash, rather than income flows, and they should refer to net, not operating flows.

This circumstance raises the burden of the analysis and the documentation to be provided, as it would demand the elaborations of additional projections and, hence, additional assumptions would be needed compared to those based on expected operating income flows, in terms of working capital requirements (i.e., expected development of payables, receivables and inventory), capital expenditures, repayments of outstanding debts and possible incurring of newly issued debts (both outside the debt under examination), and tax-related cash flows.

The third consideration regards the purpose of financial projections and the related determination of the ability to service a loan.

We understand that the goal is to support a possible ORA (e.g., the lender will not be willing to provide the loan if the borrower is unable to service it), but the question then becomes: if the borrower is able to service the loan, is the pay-back period relevant for determining the possible maturity (i.e., term of the loan) and, therefore, once again, influencing lenders' ORAs?

In fact, at least theoretically, unless clear evidence exists that a borrower will be unable to service the loan at any time in the future, which should entail recharacterizing the entire loan amount as equity, the borrower can service the loan over a long period that could go far beyond the period the lender would be willing to accept.

The final consideration concerns the possible absence of financial projections.

In this case, can the absence of financial projections be assumed as evidence of genuine uncertainty surrounding the time horizon of the investment the borrower intends to make (which should actually constitute the reason for the loan request) through the funds the lender provides? Moreover, in the event of genuine uncertainty, can it further be assumed that the loan would be short term (e.g., one year), even though it might be renewed (e.g., every year)?

Box B.3. Commentators' views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

With regard to the definition of the economically relevant characteristics of financial transactions, in general terms we recommend that the breadth of the analysis should always be commensurate with the materiality of the transaction and the size of the multinational group to maintain a fair balance between burden (for the taxpayer) and accuracy (for the benefit of tax authorities).

This very high-level consideration is all the more true considering: (i) the undeniable technicalities surrounding financial transactions; and, at least for companies that do not belong to financial sectors, (ii) the "core business" and the "sources of competitive advantage" (i.e., where the bulk of profits come from) loosely relate to financial transactions.

Conversely, with regard to material transactions, the correct and complete delineation of the factors in delineating financial transactions is crucial. Prices of financial transactions are, indeed, extremely sensitive to many different factors (e.g., date of issuance and seniority) and the analysis provided in paras. 22–36 in this regard is greatly appreciated and extremely helpful. An eventual minor implementation of the analysis of the factors could be including in para. 28: (i) the date of issuance of the loan, and (ii) the borrower's industry. Both factors are, indeed, addressed in transactions between third parties and could significantly impact the pricing.

Box B.4. Commentators' views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm's length interest rate.

The first consideration concerns the possible connections and the consequent combined interpretation with Chapters VI and VIII of the TPG on risk-free and risk-adjusted rates of return.

On risk-free rate of return

Provided that the progression of returns, along the continuum from risk-free to risk-adjusted return, depends on the breadth of functions and risks of the funder,

and assuming we are addressing intercompany debts (including those recharacterized as equity), a loan remunerated with a risk-free rate of return could be argued to make no economic sense.

Unless a default-free borrower is introduced within the logical framework, no lender would be willing to incur default or credit risk without appropriate remuneration. If the argument holds, the transaction can then be assumed not to be a loan, but a risk-free investment, such as AAA-rated bonds[2].

The consequent consideration relates to the maturity of the financial instrument yielding a risk-free return. Assuming it cannot be considered a loan, its maturity should depend only on the functions and risks of the lender (or investor). This implies that possible financial obligations and constraints on the lender must then be considered (e.g., the lender cannot invest in the long term when it must repay its short-term debts).

Moreover, a long-term debt, be it a coupon-bearing bond or a loan with interim instalments, is not yet a "pure" risk-free investment to the extent it exposes interim cash flows to "reinvestment risk"[3].

One counterargument is that an investment in a risk-free zero-coupon bond neutralises the reinvestment risk, as interim coupons have no payments. Nonetheless, it can still be argued that determining the time-horizon of the risk-free security (i.e., maturity) cannot exclude from consideration the potential impact of economic circumstances.

In fact, if it is true that the propensity to hold cash increases in volatile economies to meet unspecified contingencies, it must then be concluded that a short-term investment (possibly renewed) should be preferred to long-term investment in that environment.

In this way, the return appears far more consistent with the definition of "pure" risk-free investment, as the possible divestment of long-term bonds in an unstable environment would expose the investor to price risk due to the fluctuation of interest rates that can alter a security's market value.

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[2] Issued by governments or companies, provided they are default-free (i.e., no credit risk).

[3] In this respect, according to credited doctrine this is the ultimate reason behind the normally upward sloping term structure, empirically demonstrated by the average differential between long- and short-term returns on default-free bonds, which remunerates the investor with a "horizon premium".

Conversely, despite the above arguments, if the transaction must be assumed as a loan, its maturity must be linked to the time-horizon of the investment the borrower intends to make. This conclusion, in turn, points back to the considerations on financial projections (see our comments to paras. 17, 19 and 34).

On risk-adjusted rate of return

The risk-adjusted rate of return varies significantly depending on the holders that provide the funds, namely debt holders or equity holders. The main difference lies in the claims, as debt holders' claims are always preferential over those of equity holders.

This implies that, although the downside risk is possibly the same for both debt holders and equity holders (at worst, they can both lose all the invested capital, with the different seniority claims remaining equal), the upside risk is potentially unequal, as the debt holder can at best earn the "promised" return (i.e., cost of debt), whereas the equity holder can at best earn up to an infinite "generated" return, which is clearly higher than the "expected" return (i.e., cost of equity).

That said, when functional analysis suggests we are dealing with debt financing (in this case the funder should bear the financial risk only), the risk-adjusted rate of return should correspond to the return "promised" to debt holders (i.e., cost of debt).

However, this means that debt holders are in any case exposed to downside risk: borrowers can default. If this is true, the conclusion that the risk-adjusted rate of return ("promised" return, for debt holders) would remain unchanged if ex-post results were lower than those estimated ex-ante becomes highly debatable (see Box B.6, para. 14).

Moreover, consistently with the different risk profiles of the debt holders and equity holders, the conclusion becomes all the more debatable when functional analysis suggests we are dealing with equity financing. In this case, if the funder were to bear both the financial and the operational risk, the issue would then be determining the "expected" return, namely the cost of equity.

This makes it necessary to carefully delineate the characteristics of the equity, determine its underlying parameters and adopt a clear position as to whether it is levered (i.e., the funded entity is financed also with debt) or unlevered (i.e., the funded

entity is financed only with equity)[4]. This position is adopted based on historical or expected (i.e., implied from current stock prices) equity risk premiums, regardless of whether they are consistent with the perspective of an "optimally diversified investor" incurring only systematic or undiversifiable risk[5], and regardless of whether they are aligned with the returns generated by financial investors in relation to venture capital funds[6].

The above list is not exhaustive but includes some of the most relevant technical issues that could significantly impact the calculation of the risk-adjusted rate of return.

Para 52. On the considerations on the borrower's assets in intercompany loans

Para. 52 of the Draft, systematically placed in Section C.1 on intra-group loans, deals with the treatment of the borrower's assets and the possibility to consider them as collateral also in the absence of contractual rights arising from the intercompany loan.

The principle introduced in the paragraph: (i) appears to contradict the general principles of the TPG, and (ii) might have non-negligible practical implications in terms of both compliance burdens and tax (un)certainty.

The principle whereby the assets of the subsidiary, which is under the parent company's control and ownership, might be considered collateral also in the absence of contractual rights appears to contradict the fundamental principle of the separate entity approach under Art. 9 of the OECD Model. Indeed, pledging an asset as a security is a concrete action that must comply with several legal provisions – which produce effects also on third parties – that are set out, among other things, to accurately delineate the security (e.g., grade of the security and timing factors) and provide certainty to lenders (both current and future). Pledging an asset as a security

[4] On the theoretical continuum, the cost of debt should be lower than the unlevered cost of equity, which, in turn, should be lower than the levered cost of equity.

[5] This is one fundamental assumption of the Capital Asset Pricing Model, a model used frequently by practitioners.

[6] According to the typical remuneration scheme of venture capital funds, the overall remuneration (comprising management fees and performance remuneration) for both investors and asset managers varies depending on actual performance. This is further evidence of the highly debatable position that a risk-adjusted rate of return is unaffected by differences between ex-post and ex-ante results.

therefore cannot be considered an incidental benefit – as defined by the TPG – of being part of an MNE.

With regard to the non-negligible practical implications, it has to be pointed out that in order to consider an asset to be collateral of the intercompany loan, the MNE should: (i) before any intercompany loans are issued, analyse all the borrower's assets and consider whether they are truly free from any legal constraints (or, even worse, non-legal constraints but constraints due to the transfer pricing adjustment deriving from the application of the paragraph under examination); and (ii) during the entire life of the intercompany loan, monitor all the borrower's assets and possibly re-determine the pricing of the loans in consideration of possible future pledges granted to other entities.

The practical implications might also increase tax uncertainty and thus increase the number of disputes with tax authorities.

In demonstration of the above, in our experience entities within an MNE are financed through both internal and external financing, and it is not unlikely that collateral is granted to loans received by third parties after those between associated parties (with all the practical implications mentioned above).

In light of the above, we recommend either: (i) rephrasing the paragraph to better explain the circumstances in which assets might be considered collateral even in the absence of contractual rights, or (ii) removing the paragraph.

Box. C.2. Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance: (i) a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member; (ii) a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member. Commentators' views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

In our view, the suggested approaches could provide a benefit in terms of tax compliance, but their impact in terms of tax certainty may be remote to the extent that tax authorities are still entitled to apply different solutions. In this respect, the final provision in both approaches (whereby the group credit rating might be subject to the right of tax authorities to establish a different credit rating for a particular member) provides no further certainty than other methods generally applied and accepted in credit rating assessments (e.g., the notching-up approach, that considers as a starting point of the analysis the legal entity on a standalone basis). Moreover, an analysis that assumes as a fundamental reference point the single legal entity appears to be more aligned with the separate entity approach and permits to evaluate the specificities of each member (e.g., geographic market and financial performances of the borrower).

Box C.8.

With respect to the operation of a physical cash pool, commentators' views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

The aim of physical cash pooling is to efficiently manage the "supply of money", i.e., to provide resources when needed, at the right time and at a lower cost. Participants' balances are swept into a central account owned by the cash pool leader ("**CPL**") to be appropriately allocated based on the participants' working capital needs. Given that the CPL holds the balances, it normally performs treasury activities relating to the cash pooling. The issue is understanding the situations in which a CPL performs these activities as an entrepreneur or as a service provider. In general terms, an appropriate value chain and functional analysis needs to be performed to understand the group's business model and whether the CPL has "control over risks" and the "financial capacity to assume risks" (particularly credit risk). That said, in our experience when the parent company of an industrial group: (i) is the principal operational company with the most economic relevance (e.g., in terms of margins, assets and equity) within the group; (ii) performs core business and central support functions (whereas, by contrast, participants operate as low-risk distributors or contract/toll manufacturers); and (iii) acts as the CPL, the parent company usually performs (and assumes) all the functions (and risks) relating to the cash pooling. The "parent" CPL, thus, acts as an entrepreneur. In such a situation, particular care should be exercised if the "parent" CPL is classified as a service provider for the sole reason that, for example, the cash pooling agreements in force between group members stipulate that the credit risk of the cash pooling borrowing participants is shared among participants.

Commentators' views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular, (i) are there circumstances in which one or another of the approaches would be most suitable?; (ii) does the allocation of group synergy benefits suffice to arrive at an arm´s length remuneration for the cash pool members?; (iii) whether, in commentators' experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

With regard to the three questions reported in the Draft – Box C.8 – second paragraph, we note the following:

(i) circumstances in which the approaches mentioned in paras. 127 ("enhancing the interest rate for all participants") and 129 ("allocating the cash pool benefits to the depositors") might be suitable will be separately addressed in a specific subsequent section for the sake of clarity. With regard to the approach mentioned in para. 128 ("applying the same interest rate for all participants"), assessing the similarity of participants' credit profiles – a basic assumption to apply this approach as reported in the aforementioned paragraph – can be challenging given the subjectivity of this evaluation. It is therefore more appropriate to examine the specific characteristics of each participant (e.g., credit profile) and then allocate the benefits consistently;

(ii) the allocation of cash pooling benefits should be combined with the participants' arm's length standalone interest rates to arrive at an arm's length remuneration for the participants; and

(iii) the main issue encountered in assessing the remuneration for the cash pooling participants is – in our experience – the definition of appropriate arm's length standalone interest rates. The issue of "if and how" to allocate group synergies is generally difficult to address given: (a) the potential difficulty to collect pertinent information if the CPL is a foreign company; and (b) the absence of clear guidance on how to appropriately manage the cash pooling benefits.

Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

The economic analysis to determine the arm's length remuneration of cash pool members should be based on the following three steps:

(i) Definition of the arm's length standalone positive and negative interest rates for each participant. To manage the working capital requirements (payables and receivables over time), independent companies mainly use a bank account that normally provides: (a) a credit line (overdraft), which generates negative interest rates; and (b) the possibility for the company to have money available on demand (overnight deposit), which generates positive interest rates. The interest rates of this transaction are the comparable market references to be eventually adjusted given that the positive and negative interest rates of cash pooling participants are affected by the CPL's functional profile and the participants' creditworthiness, respectively.

(ii) Calculation of the cash pooling benefits, namely netting and volume benefits (main benefits). The netting benefit corresponds to the interest rate spread saving generated by pooling balances together. This benefit is a bank's typical remuneration and is generated as long as positive (negative) balances "absorb" negative (positive) balances (see the brown cells in the table below). The volume benefit derives from more favourable interest rates negotiated with the cash pooling bank vis-à-vis arm's length standalone interest rates. This benefit represents the "commercial bargaining power" (i.e., better conditions) of "stay-together" and is generated as long as balances increase (see the blue cells in the table below). An illustrative example of the calculation and the value trend of the netting and volume benefits is shown in the table below.

	a	b	c	d	e	f	g=a-b	N.B. (e or f)*g-(e*a-f*b)	h=(e-c)*a	i=(d-f)*b	V.B. h+i
									VOLUME BENEFIT		
Days	Participant 1 Positive Balance	Participant 2 Negative Balance	Arm's length stand-alone pos. int. rate	Arm's length stand-alone neg. int. rate	Master Account pos. int. rate	Master Account neg. int. rate	Cash Pool Leader Balances	NETTING BENEFIT	Participant 1 Volume Benefit	Participant 2 Volume Benefit	Total Volume Benefit
1	200	50	1%	6%	2%	5%	150	1,50	2,00	0,50	2,50
2	200	100	1%	6%	2%	5%	100	3,00	2,00	1,00	3,00
3	200	150	1%	6%	2%	5%	50	4,50	2,00	1,50	3,50
4	200	200	1%	6%	2%	5%	0	6,00	2,00	2,00	4,00
5	200	250	1%	6%	2%	5%	-50	6,00	2,00	2,50	4,50
7	200	300	1%	6%	2%	5%	-100	6,00	2,00	3,00	5,00
8	200	350	1%	6%	2%	5%	-150	6,00	2,00	3,50	5,50
9	200	400	1%	6%	2%	5%	-200	6,00	2,00	4,00	6,00
10	200	600	1%	6%	2%	5%	-400	6,00	2,00	6,00	8,00

(iii) Allocation of the cash pooling benefit. The allocation should be consistent with the role of the CPL (entrepreneur vs service provider) and the type of benefit (netting vs volume), as graphically summarised in the following table.

Allocation Benefit Matrix – a possible methodology

	CPL as Entrepreneur	CPL as Service Provider
Netting benefit	• Who: CPL	• Who: Participants • How: equal split among positive and negative Participants, after the remuneration of the CPL
Volume benefit	• Who: Participants • How: in proportion to the relative balances (absolute values)	• Who: Participants • How: in proportion to the relative balances (absolute values), after the remuneration of the CPL

When the CPL acts as an entrepreneur, both the CPL and the participants are entitled to earn as follows:

(i) the CPL: the netting benefit (i.e., the typical remuneration of a bank), considering that the CPL performs (assumes) the relevant functions (risks), similarly to a bank; and

(ii) the participants: the volume benefit, considering that participants (together) generate "commercial bargaining power" (i.e., better conditions) vis-à-vis the cash pooling bank. The volume benefit could be allocated among participants based on: (a) the actual volume benefit generated by each participant; (b) "all participants" balances size proportion (in line with the approach mentioned in para. 127); and (c) "lending participants" – balances size proportion (in line with the approach mentioned in para. 129). In our opinion, the second approach is generally more appropriate considering that the better conditions vis-à-vis the cash pooling bank are reached due to the "bargaining power" generated by all participants.

When the CPL acts as a service provider, both the CPL and the participants are entitled to earn as follows:

(i) the CPL: a fee based on full cost mark-up borne to operate the cash pool, considering that the CPL does not perform (assumes) the relevant functions (risks), similar to a typical service provider; and

(ii) the participants: (a) the netting benefit, whether one or more participants perform (assume) the relevant functions (risks). The netting benefit should be equally allocated among participants considering that, as reported above, it does not depend on the size of the balances. However, if lending participants actually assume the credit risk – e.g., when an explicit guarantee is required by a bank only from lending participants to cover possible negative pooled balances – the allocation of this benefit only to lending participants should be evaluated (in line with the approach mentioned in para. 129); and (b) the volume benefit (the same considerations reported above apply, i.e., those applicable when the CPL acts as an entrepreneur).

Box C.9. In the context of the last sentence of paragraph 102, commentators' views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group's policy.

Para. 102 of the Draft provides with a description of the ratio underlying cash pool transactions by referring to strategies in managing the MNE group's liquidity.

The last sentence of para. 102 contains a general preliminary remark on members' ORAs, stating as follows: "No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option".

In this regard, the matter of a particular member of an MNE group being obliged to participate in a cash pooling arrangement by the group's policy needs to be examined in relation to that member's ORAs. Indeed, once the cash pooling transaction is accurately delineated, the transfer pricing consequences of participating in a cash pooling arrangement need to be analysed in relation to the participating members' ORAs. If a clearly more attractive option than participating in a cash pooling ar-

rangement is realistically available, the remuneration of the member with the better option should be priced accordingly.

Para 106 – on the treatment of surpluses

The issue of group members that participate in cash pooling arrangements maintaining surpluses or borrowing positions that, rather than functioning as part of a short-term liquidity arrangement, become more long term, first entails addressing the issue of short-term vs long-term financing.

It is indisputable that the duration[7] between assets (investments) and liabilities (funds) must match, just as it is indubitable that cash pooling structures should service short-term liquidity needs, namely working capital needs. Moreover, it seems similarly relevant that working capital investments are "revolving" by nature, whereas tangible investments are "wasting" by nature, as their economic utility lessens over time.

Before continuing, we deem it appropriate to include a dutiful parenthesis. As may have become clear, we are referring to only monetary and tangible assets and not also to intangible assets. This is intentional as at least two observations are worth mentioning.

The first, of a conceptual nature, concerns the useful lives of intangibles that, at certain conditions and unlike tangible assets, can last indefinitely, whereas considering intangibles to be short-term and revolving assets is questionable at least.

The second, more compelling and less theoretical, concerns the "loan-to-value" ratio of intangibles that represents the portion of value that could be financed by debt. It is quite acknowledged that the "loan to value" of intangibles is significantly lower than that of tangible assets, down to a limit of "zero loan-to-value" for goodwill. This because it represents something that cannot be isolated, and hence separately transferred, from the entire business combination[8].

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[7] Technically, the duration of debt can be shorter than its maturity as the former is affected by the weight of interim payments before the repayment of principal. As the weight of interim payments increases, the duration of debt shortens. Only with zero coupon bonds, with no interim payments, do duration and maturity coincide.

[8] The definitions of goodwill differ depending on perspectives (accounting, IP law, strategic and transfer pricing[, etc.]). Nonetheless, it can represent a significant amount of the value of intangibles, hence a material portion of company profits, if the weight of intangibles on company value is taken into account.

That said, and returning to the issue of short-term versus long-term financing, companies that participate in cash pooling arrangements experience "excess cash" when short-term financing needs are lower than the cash contributed to a cash pool. This implies the presence of a durations mismatch and, therefore, an opportunity to invest in longer-term financial instruments to reap higher profits[9].

The issue then becomes how to practically determine the "excess cash". One solution could be using average industry ratios used as proxies for operating cash (e.g., cash to company value, cash to total assets and cash to revenues). Any company that holds a (positive) cash balance greater than industry averages will therefore hold excess cash[10].

As to the different industry ratios, those carrying "company value" as the denominator are the ratios to be preferred, at least theoretically. It is also true, however, that it is more onerous due to the re-expression of the balance sheet values from carrying to recoverable amounts and the reclassification from financial to functional statement[11].

A more heuristic approach might therefore be adopted – an approach that remains reasonable and is sometimes used in the transfer pricing practice – based on the selection of upper limits of market ranges of short-term deposits or financing (namely, overnight or overdraft rates for zero or target cash pools with daily sweeps).

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Please do not hesitate to contact me or any of the individuals below if you require any clarification on these comments.

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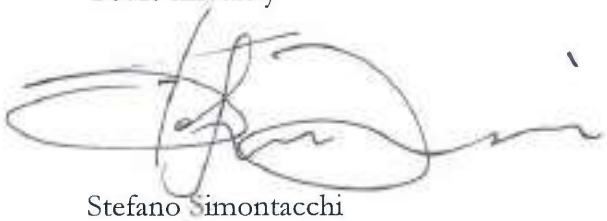
[9] See note 3 on "horizon premium".

[10] The reverse is also true: companies that participate in cash pooling arrangements experience "excess deficit" when short-term financing needs are lower than the cash absorbed into the cash pool that, indeed, at least in part, finances long-term investments. This implies the presence of durations mismatch and the need to switch, at least partially, from short-term to long-term financing, bearing the consequent higher cost. Once again, the issue then becomes how to practically determine the "excess deficit". One possible solution could be using average industry ratios used as proxies for operating deficits (e.g., short-term debt to company value, short-term debt to total assets, and short-term debt to revenues). Any company that holds a (negative) cash balance greater than industry averages will therefore bear "excess deficit".

[11] Financial statements classify assets and liabilities as current or non-current, whereas functional statements classify assets depending on their destination, and sources of capital depending on the persons that provide the funds, namely debt holders and equity holders.

We look forward to discussing any questions you have on our comments or on other specific matters raised by other commentators on the Draft.

Yours sincerely



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